ESOPs Provide a Tax-Favored Exit Strategy for Business Owners

Do you have business clients who are looking for an exit strategy for their business? Perhaps, they have thought of selling their business, but the thought of taxes due upon the sale made them a little queasy. A privately held business is quite often the owner's largest asset and generally one of the hardest to sell at market value. In addition, the success rate of businesses sold to a second generation is dismal. One of the primary reasons for this is the large amount of capital often needed to buy out the first generation. If this scenario sounds familiar, you may want to suggest the use of an ESOP (employee stock ownership plan) as a possible solution.

Facts: David Flint, age 58, owns a large excavating operation. Flint Stone & Earth Excavating, Inc. is a C Corporation, valued at $10 million. The company employs 100 employees and has annual revenues of $7 million per year.

After 16 years of developing his business and reinvesting most of the earnings back into the business, Mr. Flint has decided that he needs to diversify his assets. He has discussed selling part, or all, of his business with his accountant. He was very disappointed when his accountant told him how much he would have to pay in taxes. He is looking for ideas that might reduce the tax bite.

Solution: An ESOP is a way for a business owner to avoid immediate taxation on the sale of part, or all, of the business, while diversifying his/her assets.

Here's an example of the steps necessary to implement an ESOP.

1. A financial institution loans $5,000,000 to Flint Stone & Earth Excavating.
2. Flint Stone & Earth Excavating loans the same $5,000,000 to the ESOP.
3. The ESOP buys stock in Flint Stone & Earth Excavating from Mr. Flint.
4. Mr. Flint reinvests the money he receives in "qualified replacement property," that is, stocks and bonds of U.S. incorporated companies, as required by IRC §1042.

Each month, Flint Stone & Earth Excavating makes a contribution to the ESOP of at least $60,664 (the monthly payment due to the financial institution), and deducts the entire amount, subject to a limit of 25% of participants' compensation for principal repayments. The ESOP repays the loan to the company, and the company repays the financial institution.

Effectively, the transaction provides Mr. Flint with investment diversification, while transferring a portion of the business on a pre-tax basis.

The advantages for the client are clear, but how does this help you, as the financial professional?

The law requires that privately held companies be prepared to buy back the stock of the ESOP participant. Because this repurchase obligation can represent substantial cash flow, it is important that companies plan for this future obligation. Life insurance can be used to help fund this repurchase obligation.

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QUESTIONS TO ASK ON THE NEXT PAGE

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Prudential Financial

Employee Stock Ownership Plan (ESOP) Profile Questionnaire
Can an ESOP Meet Your Client's Needs?

Questions	*Yes*	*No*
Is your business structured as a corporation? If so, is it a C or S corporation? _________		
Are the shareholders interested in sharing equity ownership with the employees in order to attract, retain and reward employees?		
Does the company have strong secondary management with the desire and capability to take over the business?		
Is the business profitable and can its cash flow handle additional debt? (Does the business have unused debt capacity?)		
Is the business interested in: a. The buyout of a shareholder on a tax-deductible basis; b. Establishing an employer-paid retirement plan that is linked to equity performance; c. Infusing expansion capital or purchasing another company with pre-tax dollars; or d. Refinancing existing debt or obtaining new financing where the loan principal and interest is tax–deductible?		
Is the majority shareholder interested in: a. Creating a market for the sale of his/her stock; b. Diversifying his/her business interest into a portfolio of Wall Street stocks and bonds on a tax-deferred basis; c. Deferring, possibly permanently, capital gains tax on the sale of the business interest; or d. Providing liquidity on a tax-favorable basis?		
Is the business paying taxes at or near the top marginal income tax bracket?		
Does the business have a payroll of at least $1 million (excluding selling owners)?		
Has the business produced sales of at least $10 million annually for the past 5 years?		

If the answer to most of these questions is "yes," fax this questionnaire to Advanced Marketing to learn more about Employee Stock Ownership Plans (ESOP)

Broker:	Phone:
Fax:	Email:

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